CZAR RESOURCES LTD.

1985 ANNUAL REPORT

CZAR RESOURCES LTD.
and Subsidiary Companies

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Abbreviations

Throughout this report standard oil and gas abbreviations have been used. Their explanation is as follows:

BBLS	Barrels
MSTB	Thousand Stock Tank Barrels
BOPD	Barrels of Oil Per Day
MMCF	Million Cubic Feet
MMCF/d	Million Cubic Feet Per Day
BCF	Billion Cubic Feet

Annual Meeting

The Annual Meeting of Shareholders of Czar Resources Ltd. will be held on Friday, April 25, 1986 at 3:00 p.m., in the Glencoe Room of the Calgary Convention Centre, 120 Ninth Avenue S.E., Calgary, Alberta.

PLEASE NOTE:
If you are a registered shareholder of Czar, please direct any queries regarding changes of address, loss of certificates, etc. to our transfer agent, Canada Trust at their Calgary office.

If you are not registered with the transfer agent and receive material from the Company directly, please send any changes of address to Czar Resources Ltd. in Calgary to the attention of the Investor Relations Department.

Apr. 13, 1986

CZAR RESOURCES LTD.
and Subsidiary Companies

Highlights

FINANCIAL	1985	1984 (restated)
GROSS REVENUE		
Canada	$13,547,085	$13,306,559
United States	1,683,511	2,363,134
Total	$15,230,596	$15,669,693
Cash flow from operations	$ 5,056,629	$ 4,301,084
Cash flow per share	$ 0.43	$ 0.37
Net earnings	$ 3,111,746	$ 2,356,165
Net earnings per share	$ 0.27	$ 0.21
Capital expenditures	$ 7,447,907	$ 4,327,735
Total assets	$40,683,257	$33,371,710
Common shares outstanding	11,651,886	11,628,553
OPERATING		
Production (before royalties)		
Crude oil and natural gas liquids (BBLS)	187,364	201,477
Average daily production (BOPD)	513	551
Natural gas (BCF)	5.8	6.0
Average daily production (MMCF/d)	15.9	16.5
Drilling Activity		
Gas completions	10	17
Oil completions	5	12
Dry and abandoned	5	4
Total wells	20	33
Undeveloped Land Holdings		
Net Acres		
Alberta	57,993	86,973
British Columbia	122,008	102,859
Total net acres	180,001	189,832

RESERVES, before royalties — Proved and probable

	OIL (MSTB)	GAS (MMCF)
Canada	1028.1	211,640
United States	79.5	393
TOTAL	1,107.6	212,033

CZAR RESOURCES LTD.
and Subsidiary Companies

To The Shareholders

During 1985 considerable progress was made in improving the financial and operating strengths of the Company.

The combination of a careful expenditure program conducted throughout the year coupled with steady growth in gas marketing placed the Company, at year end, in a position which allowed for continued expansion during 1986.

Significant achievements during 1985 were:

— improvements in cash flow and earnings

— a substantial increase in the proportion of gas reserves under contract

— completion of major new pipeline projects and

— improved market recognition.

Highlights of the Company's progress were:

Financial

Czar reported record earnings and cash flow for 1985. As in 1984, the Company funded the bulk of its capital expenditures from internally generated cash flow and additional funds necessary were derived from existing credit lines.

The interest rate on the Company's term preferred shares and on a portion of the revolving credit line was fixed thereby limiting interest rate exposure. At year end, Czar entered into a flow-through share agreement to expend up to $3 million on exploration during 1986.

Natural Gas Marketing

During 1985 the Company maintained all of its existing industrial contracts and commenced deliveries to a number of new customers.

Of significance was Czar's contract for the first direct gas export between a Canadian producer and a United States end user. In addition, the Company concluded the first gas sale to a non-eligible British Columbia industrial purchaser under the new B.C. provincial regulations.

Industrial sales increased during the year and a number of the new contracts, which commenced subsequent to year end, will ensure substantial volume increases starting in the first quarter of 1986.

Outlook

The foregoing developments all indicated an extremely active and positive outlook for fiscal 1986. Indeed, expanded gas sales and higher cash flows have exceeded forecasts in the early months of 1986.

Furthermore, the positive effects of recent changes to taxation and royalty structures made by the Federal and Provincial governments greatly benefited the industry and resulted in the most promising outlook since the advent of the National Energy Program.

With the Company's continuing turnaround, it has therefore been a major disappointment to see the rapid fall in oil prices have such an immediate negative impact on the oil and gas industry. While a decline in petroleum prices had been anticipated, and Czar's projected expenditure program had been staged over the year to allow for a clear pricing picture to develop, nevertheless, the extreme price drops have been of stunning magnitude.

Czar's reaction to these new developments has been swift and has resulted in virtual termination of new capital expenditures, the freezing of any staff additions and the commencement of a careful review of costs with a view to further retrenchment. In addition, any projects undertaken during the year will be reviewed in the light of current energy pricing, and will likely result in the Company being restricted to a limited amount of gas development activity.

On a more positive note, it is possible that a combination of political and economic forces including reduced oil production and increased demand, could lead to an oil price recovery by the end of the year. The almost inevitable collapse of exploration and development drilling will aid in reducing volumes of new oil and gas brought to the market and gradually restore a production balance and pricing stability.

However, with the Company's long-term refinancing in place, 70% of its revenues derived from natural gas and continuing expansion of gas sales, Czar's position during 1986 is projected to be stable despite extremely low oil prices.

I would like to thank the staff for their diligent and successful efforts during the past year.

On behalf of the Board,

R. W. Lamond

March 27, 1986

CZAR RESOURCES LTD.
and Subsidiary Companies

Financial

During the year the Company made satisfactory financial progress in that improvements in earnings and cash flow were coupled with an active, substantially internally-financed development program.

Earnings for 1985 totalled $3.1 million, a 32% increase from the restated $2.4 million reported during 1984. Cash flow increased by 18%, from $4.3 million or $0.37 per share in 1984 to $5.1 million or $0.43 per share.

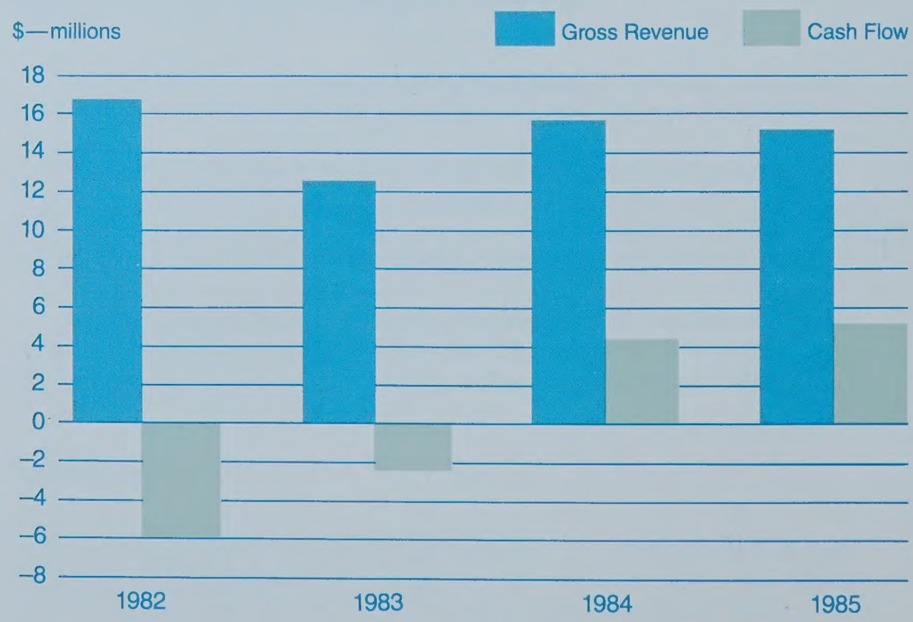
Financial results improved due to the Company's 1984 refinancing being in effect for the first full year and thereby reducing total debt servicing to $5.3 million from $6.6 in 1984. Overhead costs were also reduced during the year to $1.5 million which is the lowest level attained in five years.

Operating results over the past four years have improved dramatically and cash flow from operations, before financing charges, totalled $10.4 million in the current year, compared with $3.8 million in 1982. The Company's fixed charge coverage in 1985 increased to 1.95:1 from 1.72:1 in the prior year.

During 1985 the Company expended $7 million on fixed assets comprising $1 million for development drilling, $4.3 million for production facilities and $900,000 to hold and upgrade Czar's land inventory. The Company's financial plan has been to fund all fixed asset costs from cash flow, but at the end of the fiscal year a sudden increase in the number of new gas contracts led to higher than forecasted expenditures. In this regard Czar made considerable investments in production facilities in Gadsby in central Alberta and in Monias in British Columbia in order to commence gas deliveries in November 1985 and to benefit from the seasonal period of higher gas demand.

Despite the predicted downward trend of interest rates, management felt it was prudent to fix the Company's cost of borrowed funds. Over 90% of the Company's outstanding debt was fixed at an average rate of 7.8% for three

Revenue & Cash Flow

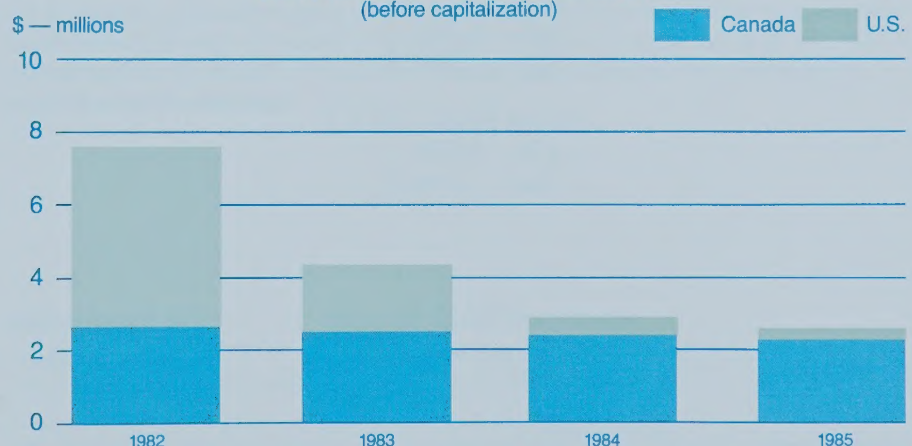


years which gives the Company some degree of protection from upward interest rate fluctuations.

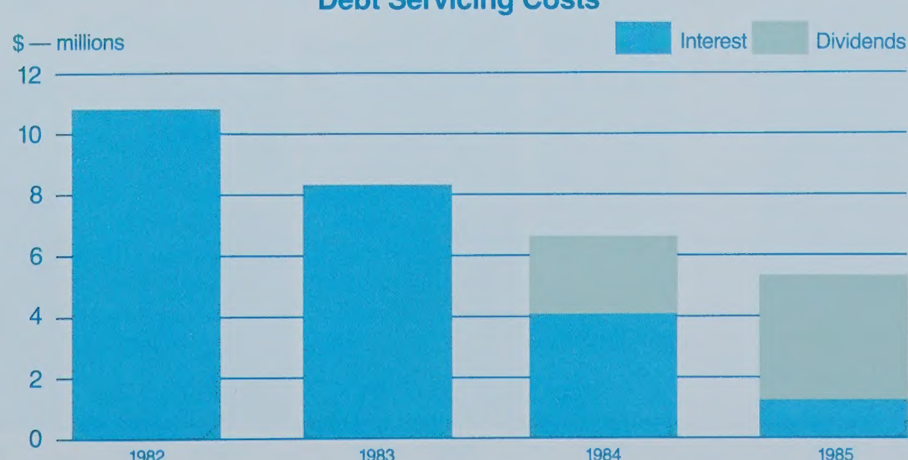
Due to prevailing low energy prices and using Czar's new reserves report, the Company has decided to reevaluate its asset base using the proposed Canadian Institute of Chartered Accountants ceiling test for full cost accounting companies. The computation, which uses non-escalated pricing and takes into account future financing and overhead costs, has resulted in a restatement of the Company's oil and gas asset base to $30 million at the end of 1985. In order to reflect the effect this new calculation would have had on prior years' assets, the Company has restated its 1983 figures on the same basis, resulting in a retroactive adjustment to fixed assets and retained earnings in the 1985 financial statements. Cash flow reported for prior years has not changed. While this treatment of asset values may be considered to be very conservative especially as oil and gas pricing could improve over the life of the assets, it is the opinion of the Board that a conservative approach is appropriate at this time.

At year end, the Company entered into an agreement with National Investors Management Ltd., to expend up to $3 million on exploration projects during 1986. This flow-through share offering closed the last week of March, 1986.

General & Administrative Costs
(before capitalization)



Debt Servicing Costs



Production

The Company's 1985 production levels of oil and gas were slightly lower than the rates in 1984. As in prior years, declines in United States production rates were virtually offset by improvements in Canada.

In Canada, oil and natural gas liquids production increased from 388 BOPD in 1984 to 396 BOPD in 1985. In the United States oil production declined to 118 BOPD from 163 BOPD during 1984 as a result of natural depletion of the wells.

Gas production for 1985 averaged 15.9 MMCF per day, with the slight decrease from the prior year resulting from payouts and adjustments to interests in a number of producing properties.

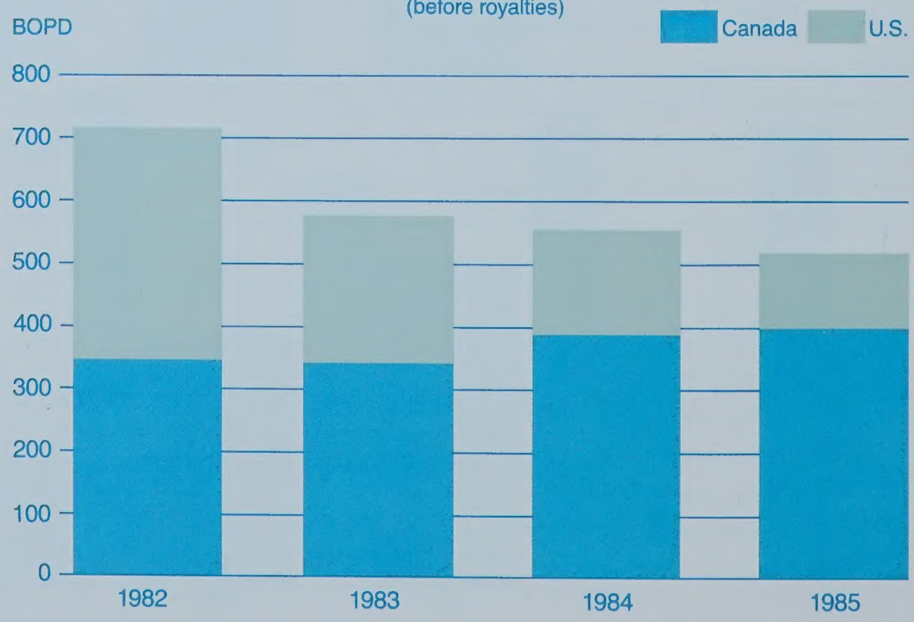
In Canada, the average gas price of $2.07/MCF for 1985 showed a slight decline from 1984 while oil and natural gas liquids prices increased to $36.26 per barrel. Czar's lower than average gas price results from the high proportion of industrial gas sold by the Company.

AVERAGE PRODUCT PRICES

	1985	1984
Canada ($CDN)		
Oil — $/BBL	**36.26**	34.99
Gas — $/MCF	**2.07**	2.11
United States ($U.S.)		
Oil — $/BBL	**35.57**	30.28
Gas — $/MCF	**4.21**	3.80

Oil Production

(before royalties)



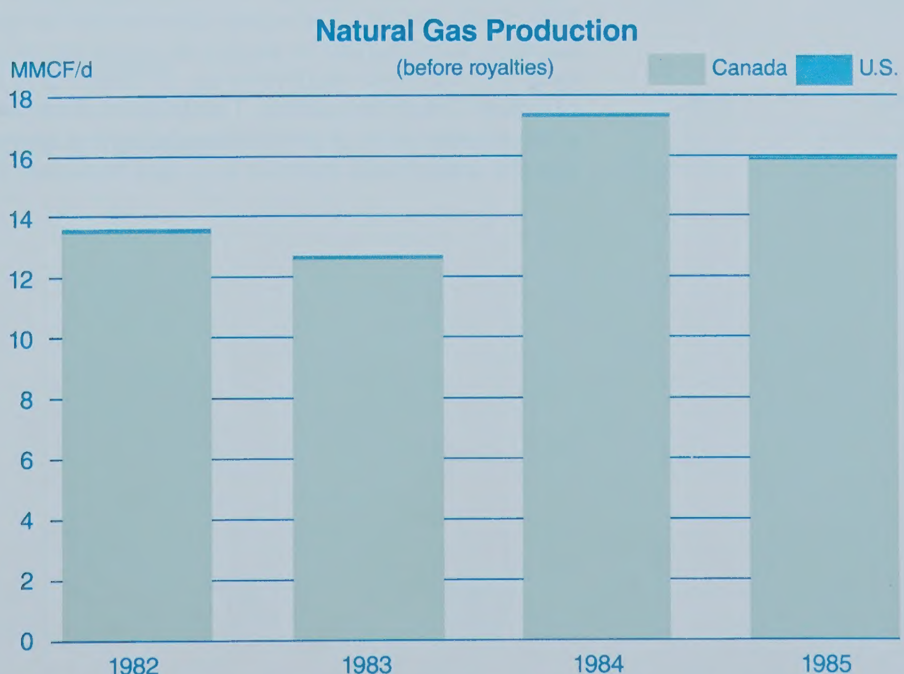
Natural Gas Marketing

During 1985, the Company continued to enhance its expertise in the direct gas marketing field and quickly expanded the number of its direct sale contracts. The Company's policy has been firstly to continue to maintain satisfactory service to existing customers and secondly to take on new contractual obligations as gas properties are developed or connected to pipelines. Part of the effort during 1985 entailed upgrading facilities and adding new wells to existing contracts, while dedicating and contracting larger blocks of shut-in gas to new customers.

Gas deliveries under Czar's industrial contracts totalled 11.9 BCF during the year, up 6%, from 11.2 BCF sold during 1984.

In light of the rapid and continuing deregulation of the natural gas industry in Canada and the United States, the Company has attempted to achieve a diversity in the duration and nature of its contract obligations. Thus, with a variety of purchasers and a mix of long-term and spot contracts, Czar is hedged from many industry and pricing uncertainties.

The Company's efforts in this field have been considerably aided by the Federal-Provincial gas agreement which became effective November 1, 1985. Under its provisions, essentially all natural gas transactions will be deregulated by the end of 1986, export price policy has become more flexible and regulatory procedures have been expedited. Though there will be a resulting decline in gas prices this year, the fact that Czar has already been selling a large proportion of its gas on the lower-priced spot market will minimize the effect of reduced natural gas prices on the Company's cash flow and earnings.



Deliveries to Czar's Alberta supply contracts with Sherritt Gordon and Alberta Gas Chemicals were satisfactory during 1985. The Company also supplied gas to a spot contract in Alberta and finalized two additional contracts with utility purchasers.

As the bulk of Czar's unconnected gas reserves are situated in the Province of British Columbia, the Company's major effort during the year was directed toward marketing B.C. gas. Throughout 1985 however, rapidly falling prices of United States domestic gas, following the U.S. industry's deregulation on January 1, 1985, led to fierce market competition and an essential requirement that Czar continually stay abreast of current developments.

As a result of the constantly changing U.S. market place, Czar's first export contract, to an ammonia plant located in Oregon, was briefly curtailed and required several price redeterminations in order that the Company's gas supply remain competitive. Czar managed to retain the contract and through the year delivered 1.7 BCF to October 31, 1985.

Czar also entered into gas contracts to supply up to 25 million cubic feet per day to Weyerhaeuser's bleached paper facility at Longview, Washington and to Mobil Oil's refinery at Ferndale, Washington. Lengthy delays were caused by pricing and transportation problems, but deliveries to both facilities began shortly after year end. The Company has been very active in the Pacific Northwest region of the United States, and has numerous other gas contracts in various stages of completion.

Due to the new policies of the British Columbia government which promoted deregulation and allowed direct sales to industrial users, Czar made a concerted effort during the year to sell more gas to local industries.

The effort resulted in a successful tender for a three year contract to supply the Prince George Pulp and Paper plant with up to 15 million cubic feet of gas per day. Deliveries commenced on November 1, 1985. In addition, Czar agreed to supply discount gas which is surplus to its long-term contract requirements, to United Gas Brokers Ltd., a consortium of British Columbia utilities. The UGB contract will enable Czar to maintain a reasonable level of production during the normally low demand summer months and should improve B.C. gas revenues for the year.

Reserves

As Czar's reserves had not been evaluated by an independent petroleum consultant since 1983, the Company commissioned a new report with an effective date of October 31, 1985.

Since the prior report, a significant number of factors have affected the reserves appraisal, including:

- the effects of current energy pricing on long-term production economics,
- recompletions and reevaluations of existing wells,
- relinquishment of semi-proven leases, and
- reappraisals resulting from new production information.

Furthermore, Czar, in conjunction with the independent petroleum consultant, has taken a very conservative approach to estimating reserves by removing a number of marginal and remote properties from reserve consideration.

At year end Czar's reserves, before royalties, were:

	OIL (MSTB)	GAS (MMCF)
Canada		
Proved producing	936.4	88,428
Proved non-producing	51.7	77,323
TOTAL Proved	988.1	165,751
TOTAL Probable	40.0	45,889
TOTAL Canada	1,028.1	211,640
United States		
Proved producing	79.5	393
TOTAL Reserves	1,107.6	212,033

Exploration and Development

During 1985 the Company continued its policy of drilling development wells in gas pools where ready access to markets was assured. Further to this plan, Czar farmed out a number of low risk but low return oil prospects to industry partners.

The Company participated directly in 22 wells during the year which resulted in 10 gaswells, five oilwells and seven dry holes. Of these wells twelve were drilled at no cost to Czar. Three were oilwells, four were gaswells and five were dry holes.

The Company's continuous development program in Gadsby and adjacent areas of central Alberta has now resulted in 30 completed gaswells and represents the largest gas reserve, net to Czar, in Alberta. Due to the low risk and inexpensive nature of this development drilling program, the Company retained larger than normal working interests in the wells drilled during 1985, ranging from 40% to 100%.

In addition to the drilling activity, a number of cased wells were recompleted during the year. In British Columbia, Czar recompleted the North Cache b-64-I well as a Coplin gaswell. The well, in which Czar's 24% interest increases to 44% after payout, flowed at 4.8 MMCF/d and has been placed onstream to an industrial contract. Also in B.C., completion of the Charlie Lake zone in the Czar Boundary 6-8-87-13 W6M well resulted in the sustained production of 35 BOPD. Czar owns a 34% revenue interest in the well, which qualifies for a three year royalty holiday. In Alberta, at Medicine River, the Company drilled a Pekisko well, 4-32-38-2 W5M which has been producing at 1.0 MMCF/d with 56 BBLS of condensate.

With the success in negotiating new gas contracts, the bulk of the Company's fixed asset budget was invested in production facilities. In Alberta, over 27 miles of pipeline and a central dehydration and compression facility were installed to place the unconnected Gadsby wells on production. The facilities have enabled gross gas deliveries to increase from an average of four MMCF/d to 13 MMCF/d, of which Czar's net share is 5.3 MMCF/d.

In British Columbia, the Company completed the tie-in of gas reserves in the North Monias pool in two stages. In anticipation of being able to contract additional gas reserves and due to environmental and construction constraints, a major river crossing, involving the laying of two 8″ lines across the Peace River, was completed in early September.

With the award of the Prince George Pulp and Paper contract in early October, the necessary pipelines and production facilities were completed and gas sales commenced December 25, 1985 at rates of up to 10 MMCF/d. The completion of these facilities is important as they will provide for the tie-in of additional shut-in wells in the North Monias and Boucher pools as new market outlets are developed.

Field gathering systems were extended to wells at Helmet, Cabin and North Cache in British Columbia which increased, by 14 MMCF/d, gas deliverability available for Czar's industrial contracts.

Auditors' Report

To the Shareholders of
Czar Resources Ltd.

We have examined the consolidated balance sheet of Czar Resources Ltd. as at October 31, 1985 and the consolidated statements of earnings, deficit and source and use of cash for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of the company as at October 31, 1985 and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied, after giving retroactive effect to the change in the method of accounting for oil and gas operations as explained in Note 2, on a basis consistent with that of the preceding year.

Calgary, Canada
March 27, 1986

Thorne Riddell
Chartered Accountants

CZAR RESOURCES LTD.
and Subsidiary Companies

Consolidated Balance Sheet

As at October 31, 1985

ASSETS	1985	1984 (restated note 2)
Current Assets		
Cash	$ 2,382,387	$ 706,204
Accounts receivable	7,111,831	6,505,967
Inventory of supplies, at lower of cost and net realizable value	277,233	308,620
	9,771,451	7,520,791
Fixed Assets		
Petroleum and natural gas leases and rights including exploration, development and equipment thereon, at cost	36,277,984	29,523,433
Other	1,356,943	1,196,884
	37,634,927	30,720,317
Accumulated depletion and depreciation	6,723,121	4,869,398
	30,911,806	25,850,919
	$ 40,683,257	$ 33,371,710

LIABILITIES	1985	1984
Current Liabilities		
Accounts payable and accrued liabilities	$ 14,350,013	$ 11,905,211
Current portion of long-term debt	270,000	540,000
	14,620,013	12,445,211
Long-term Debt (note 5)	17,500,000	15,510,000
Preferred shares of a subsidiary company (notes 3 and 4)	55,000,000	55,000,000
CAPITAL STOCK AND DEFICIT		
Capital Stock (note 6)	12,916,385	12,881,386
Deficit (note 6)	(59,353,141)	(62,464,887)
	(46,436,756)	(49,583,501)
	$ 40,683,257	$ 33,371,710

Future Operations (note 4)

Approved by the Board:

, Director

, Director

CZAR RESOURCES LTD.
and Subsidiary Companies

Consolidated Statement of Earnings

Year Ended October 31, 1985

	1985	1984 (restated note 2)
Revenue		
Production	**$14,937,793**	$15,304,204
Less: Provincial royalties	**1,978,393**	2,031,925
Freehold royalties	**849,486**	677,398
Petroleum and gas revenue tax	**574,490**	737,335
Alberta royalty tax credit	**(608,575)**	(487,092)
	2,793,794	2,959,566
Net production revenue	**12,143,999**	12,344,638
Principal and interest from property dispositions	**2,186,505**	2,588,045
Other	**900,092**	737,010
	15,230,596	15,669,693
Expenses		
Production	**3,393,825**	2,969,278
General and administrative	**1,462,688**	1,784,618
Interest on long-term debt	**1,265,207**	4,114,822
Depletion and depreciation	**1,944,883**	1,944,919
	8,066,603	10,813,637
Earnings before preferred share dividends	**7,163,993**	4,856,056
Dividends on preferred shares of a subsidiary company (note 3)	**4,052,247**	2,499,891
Net earnings	**$ 3,111,746**	$ 2,356,165
Per Common Share (note 9)		
Net earnings	**$0.27**	$0.21
Cash flow	**$0.43**	$0.37

CZAR RESOURCES LTD.
and Subsidiary Companies

Consolidated Statement of Deficit

Year Ended October 31, 1985

	1985	1984
Beginning of year		
As previously reported	**$ 1,472,277**	$(46,767,254)
Change in accounting policy (note 2)	**(63,937,164)**	(64,821,052)
As restated	**(62,464,887)**	(111,588,306)
Net earnings	**3,111,746**	2,356,165
Authorized reduction of share capital applied to deficit (note 6)	**—**	46,767,254
End of year	**$(59,353,141)**	$(62,464,887)

Consolidated Statement of Source and Use of Cash

Year Ended October 31, 1985

	1985	1984 (restated note 2)
Operating Activities		
Net earnings	**$ 3,111,746**	$ 2,356,165
Depletion and depreciation	**1,944,883**	1,944,919
Working capital provided by operations	**5,056,629**	4,301,084
Net change in non-cash working capital items and long-term receivables	**1,870,325**	2,983,908
Investing Activities		
Additions to fixed assets	**(7,005,770)**	(3,849,735)
Financing Activities		
Increase (decrease) in bank loan	**2,260,000**	(58,292,525)
Discharge of limited partnership redemption obligations	**(540,000)**	(540,000)
Issue of common shares	**34,999**	—
Issue of preferred shares of a subsidiary company	**—**	55,000,000
Increase (decrease) in cash	**1,676,183**	(397,268)
Cash at beginning of year	**706,204**	1,103,472
Cash at end of year	**$ 2,382,387**	$ 706,204

Notes to Consolidated Financial Statements

Year Ended October 31, 1985

1. Accounting Policies (see note 4)

(a) Principles of Consolidation

The consolidated financial statements include the accounts of Czar Resources Ltd. and its two wholly-owned subsidiary companies.

(b) Foreign Currency Translation

The accounts of the foreign subsidiary are translated to Canadian dollars on the following basis:

(i) monetary assets and monetary liabilities at the rate of exchange in effect as at the balance sheet date.

(ii) non-monetary assets and non-monetary liabilities at the rates of exchange in effect at the dates on which the assets were acquired or the liabilities incurred.

(iii) revenue and expenses (excluding depreciation and depletion which are translated at the same rate as the related assets) at the average rate of exchange for the year.

(iv) gains or losses resulting from such translations are charged or credited to earnings.

(c) Petroleum and Natural Gas Operations

(i) The Company follows the full cost method of accounting for petroleum and natural gas operations whereby all costs of exploring for and developing petroleum and natural gas reserves are capitalized by cost centre. A separate cost centre is established for each country in which the Company operates, presently Canada and the United States. Costs include land acquisition costs, geological and geophysical expenditures, carrying charges on non-producing property, costs of drilling both productive and non-productive wells, related overhead expenditures and capitalized interest related to major development projects. Costs of acquiring and evaluating unproved properties and certain major development projects are excluded from the depletion calculation until it is determined whether or not proved reserves are attributable to those properties, major development projects are complete, or impairment occurs. Costs are depleted by cost centre using the composite unit of production method based upon estimated proved reserves. In calculating depletion, crude oil reserves are converted to equivalent units of natural gas based on the relative energy content of each product.

(ii) Aggregate costs in each cost centre which can be carried forward for amortization against revenues of future periods (the "cost ceiling") are limited to an amount equal to the estimated value of future net revenues from proved reserves, based on current prices and costs, plus the lower of cost or estimated fair value of unproved properties and major development projects. The aggregate value of such future net revenues and unproved properties and major development projects for all cost centres is further reduced by estimated future aggregate general and administrative expenses, financing costs and income taxes.

(iii) Under certain drilling programs, a significant portion of the consideration for the sale of properties by the Company to limited partnerships is payable to the Company by installments. Principal and interest payments, in the aggregate, may not exceed a fixed percentage of net revenue from the wells drilled. Unpaid principal installments total $45,871,832 at October 31, 1985 (1984 — $46,816,510). Such principal and interest payments are recorded as and when received.

(iv) All of the Company's exploration and development activities related to petroleum and natural gas are conducted with others; the Company records only its proportionate interest in such activities.

(d) Depreciation

Depreciation of petroleum and natural gas production equipment and related facilities is provided on the composite unit of production method based on estimated proved reserves of each cost centre. Depreciation of other equipment is provided on a straight-line basis at rates which are estimated to amortize the cost of the assets over their useful lives.

2. Change in Accounting Policy

Prior to November 1, 1984 the Company's cost ceiling provided that the aggregate capitalized petroleum and natural gas costs could not exceed the present value of future net revenues from estimated production of proved reserves at escalated prices and costs. Effective October 31, 1983 the Company retroactively changed its accounting policy in respect of its cost ceiling to the policy described in note 1. The comparative financial statement for the year ended October 31, 1984 has been restated to give effect to this change. As a result of this change, net earnings increased by $883,888 ($.08 per share) and $2,607,212 ($.22 per share) for 1984 and 1985, respectively. The cumulative effect of the change to October 31, 1983 results in an increase in the deficit of $64,821,052 and a decrease in fixed assets of $64,821,052.

3. Financial Reorganization

In 1984, the Company negotiated a refinancing of its indebtedness with its banker and successfully completed a financial reorganization.

On May 15, 1984, a wholly-owned subsidiary, Czar Financing Alberta Ltd. issued to the Company's banker, $55,000,000 of cumulative, redeemable, non-voting first preferred shares. The proceeds of the issue were borrowed by Czar Resources Ltd. (Czar) from its subsidiary and were used to reduce its long-term bank loan. Czar has the obligation, on or before the last day of February in each year, commencing on February 28, 1985, to repay amounts borrowed from its subsidiary, such repayment amounts to be Czar's defined "Excess Cash Flow", less $200,000, as determined for Czar's immediately preceding fiscal year. The subsidiary in turn, is obliged to use such funds to redeem its preferred shares by February 28, each year. No repayment of Czar's indebtedness to its subsidiary and redemption of preferred shares is required on February 28, 1986 because "Excess Cash Flow" in respect of Czar's fiscal year ended October 31, 1985 is insufficient to require such repayment and redemption. All of the preferred shares must be redeemed on or before March 15, 1989 from additional bank borrowings or alternative financing.

Upon certain events of default, the bank has the right to sell the preferred shares to Czar (see note 4). In the event Czar is unable to consummate the purchase, the bank may assert its rights under a floating charge debenture on all the assets of Czar and assignments of accounts receivable and certain petroleum and natural gas properties and revenue interests therein. The Company has agreed with the bank that it will not encumber any of its assets or dispose of any of its petroleum and natural gas properties, other than to its joint venture participants in the normal course of business, without, in each case, the consent of the bank.

Dividends on the preferred shares are payable quarterly on the last day of March, June, September and December. Czar has negotiated a dividend rate, to February 15, 1988, which approximates 7.35% per annum. Thereafter the dividend rate will be one half bank prime for such quarter plus 1%. Czar is required to make contributions to its subsidiary sufficient to pay these dividends.

In the five year term of the preferred shares, the Bank is to receive warrants to purchase 1,162,855 common shares of the Company. As at October 31, 1985 the Bank has received 697,713 warrants and will receive 232,571 warrants in each of the 1986 and 1987 fiscal years. The warrants will be exercisable for a period of five years at the closing market price of the common shares at the dates on which the warrants are issued.

4. Future Operations

A comparison of the aggregate of the Company's working capital deficiency and bank loans at October 31, 1985 with the approved lines of credit indicates that the Company's ability to meet current obligations is dependent upon the continued support of the Company's banker. In March, 1986 the bank notified the Company that in its view it is entitled to sell the preferred shares to the Company at any time, and the bank and the Company have commenced discussing the potential renegotiation of the Company's financing. The Company has met all of its interest and dividend payments to date.

These financial statements are prepared on the basis that the Company will continue to operate and meet its obligations throughout its next fiscal period subsequent to October 31, 1985.

5. Long-Term Debt

	1985	1984
Bank loan, bearing interest at prime plus ¼%	**$15,000,000**	$12,740,000
Bank loan, non-interest bearing	**2,500,000**	2,500,000
Amounts payable pursuant to the discharge of limited partnership redemption obligations, non-interest bearing	**270,000**	810,000
	17,770,000	16,050,000
Less current portion	**270,000**	540,000
	$17,500,000	$15,510,000

The Company has a revolving line of credit of $15 million with its banker. A non-interest bearing loan of $2.5 million has been established to cover accrued but unpaid interest on the previous bank loans. The bank loans are evidenced by notes payable on demand to the bank and are secured by the floating charge debenture and other security described in note 3.

The bank loans, advanced under a credit facility which is reviewed annually, have no specific terms of payment. The loans are to be paid out of future oil and gas production revenues.

Subsequent to October 31, 1985 the interest rate on $8,000,000 of the interest bearing bank loan was fixed at a rate of 10.98% to November 8, 1988.

6. Capital Stock and Deficit

(a) Authorized Capital Stock

10,000,000	First preference shares issuable in series
10,000,000	Second preference shares issuable in series
30,000,000	Common shares

(b) Issued Capital Stock	**Number of Shares**	**Consideration**
Common shares outstanding at October 31, 1984 and October 31, 1983 (after authorized reduction of share capital during 1984 of $46,767,254).	**11,628,553**	$12,881,386
Issued for cash on exercise of stock options	**23,333**	34,999
Common shares outstanding at October 31, 1985	**11,651,886**	$12,916,385

(c) Common Share Options

At October 31, 1985 directors, officers and employees held options to purchase 891,200 common shares of the Company at prices ranging from $1.50 to $1.70 per share exercisable from time to time to August 1990.

A director of the Company is an officer of a joint venture partner of the Company which has the option to exchange the oil and natural gas assets developed through its joint venture with the Company for shares of the Company. The number of shares issuable will be determined by a calculation based upon reserve estimates of the assets to be exchanged at October 31, 1986. Based upon reserve estimates at October 31, 1985, the Company would issue approximately 529,000 common shares in exchange for assets worth approximately $2.9 million.

(d) Common Share Purchase Warrants

At October 31, 1985 1,297,713 common share purchase warrants were outstanding, entitling the holders of 600,000 warrants to purchase one common share at the price of $17.00 on or before April 30, 1986; and entitling the Company's banker, the holder of 697,713 warrants, to purchase 232,571 common shares at $1.86, on or before May 15, 1989, 232,571 common shares at $1.60 on or before October 31, 1989, and 232,571 common shares at $2.16 on or before October 31, 1990.

(e) Deficit

At the special and annual general meeting of the shareholders held on April 18, 1984 the shareholders authorized:

(i) the reduction of the capital reserve fund by $145,500 which was applied against the deficit, thereby reducing the deficit to $46,767,254 as of October 31, 1983, before the increase in the deficit as a result in the change in accounting as described in note 2.

(ii) the reduction of the common share capital by $46,767,254, being the amount of the deficit as of October 31, 1983, before the increase in the deficit as a result in the change in accounting as described in note 2 after reduction of the capital redemption reserve fund.

7. Income Taxes

There is no provision for deferred taxes in 1985 and 1984 as there are sufficient unrecorded tax losses for accounting purposes available to offset future earnings for a number of years. A summary of items which reduce taxable income for accounting purposes is as follows:

	1985	1984
Net earnings	**$ 3,111,746**	$ 2,356,165
Increase (decrease) in taxable income resulting from:		
Non-deductible preferred share dividends	**4,052,247**	2,499,891
Non-deductible provincial royalties and lease rentals	**2,103,486**	2,279,922
Alberta royalty tax credits	**(608,575)**	(487,092)
Non-deductible petroleum and gas revenue tax	**574,490**	737,335
Resource allowance	**(2,156,851)**	(2,097,297)
Earned depletion allowance	**(1,025,821)**	(810,302)
Application of prior years' losses	**(6,045,709)**	(4,477,676)
Other	**(5,013)**	(946)
Taxable Income for Accounting Purposes	**$ 0**	$ 0

At October 31, 1985, the Company has the following amounts available to reduce future years' income for tax purposes, the tax effect of which has not been recorded in the accounts.

United States losses which will expire beginning in 1995 . . .	$22,368,000
Excess of the tax value of fixed assets over the net book value of fixed assets	54,935,000
	$77,303,000

8. Segmented Information

The Company has a single line of business which is the exploration for and the

development and production of petroleum and natural gas. Information about the Company's operations by geographic segment is as follows:

	Year Ended October 31, 1985		
	Canada	**U.S.A.**	**Total**
Identifiable assets	**$35,651,994**	**$5,031,263**	**$40,683,257**
Net production revenue	**$10,460,488**	**$1,683,511**	**$12,143,999**
Principal and interest from property dispositions	**2,186,505**	—	**2,186,505**
Other	**900,092**	—	**900,092**
	13,547,085	**1,683,511**	**15,230,596**
Less:			
Production expense	**2,866,480**	**527,345**	**3,393,825**
Depletion and depreciation	**1,944,883**	—	**1,944,883**
Operating profit	**8,735,722**	**1,156,166**	**9,891,888**
General and administrative costs	**2,315,817**	**279,409**	**2,595,226**
Capitalized general and administrative costs	**(610,130)**	—	**(610,130)**
Bad debts recovered	—	**(522,408)**	**(522,408)**
Interest expense	**1,407,785**	**(142,578)**	**1,265,207**
	3,113,472	**(385,577)**	**2,727,895**
Earnings before preferred share dividends	**5,622,250**	**1,541,743**	**7,163,993**
Dividends on preferred shares of a subsidiary company	**4,052,247**	—	**4,052,247**
Net earnings	**$ 1,570,003**	**$1,541,743**	**$ 3,111,746**

	Year Ended October 31, 1984		
	Canada	**U.S.A.**	**Total**
Identifiable assets	$30,118,574	$3,253,136	$33,371,710
Net production revenue	$ 9,981,504	$2,363,134	$12,344,638
Principal and interest from property dispositions	2,588,045	—	2,588,045
Other	737,010	—	737,010
	13,306,559	2,363,134	15,669,693
Less:			
Production expense	2,682,743	286,535	2,969,278
Depletion and depreciation	1,944,919	—	1,944,919
Operating profit	8,678,897	2,076,599	10,755,496
General and administrative costs	2,454,192	460,186	2,914,378
Capitalized general and administrative costs	(761,599)	—	(761,599)
Bad debts recovered	—	(368,161)	(368,161)
Interest expense	3,905,616	209,206	4,114,822
	5,598,209	301,231	5,899,440
Earnings before preferred share dividends	3,080,688	1,775,368	4,856,056
Dividends on preferred shares of a subsidiary company	2,499,891	—	2,499,891
Net earnings	$ 580,797	$1,775,368	$ 2,356,165

9. Net Earnings and Cash Flow Per Common Share

Net earnings and cash flow per common share are calculated using the average number of common shares outstanding during the year of 11,634,105. The calculation of cash flow per common share is based on "Working capital provided by operations" as reflected in the Consolidated Statement of Source and Use of Cash.

10. Subsequent Event

Subsequent to October 31, 1985, the Company executed a letter of intent with an investment company whereby Czar will make development and exploratory drilling expenditures on behalf of this company's investors and will issue common shares in consideration for cash. The tax benefits associated with these expenditures will flow through to the ultimate investors. Czar may spend up to $3 million under this arrangement until expiry on December 31, 1986. The arrangement closed in March 1986. The shares will be issued at a premium to the market price at the date the arrangement was entered into.

11. Contingent Liabilities

The Company is contingently liable in respect of alleged obligations to certain limited partnerships totalling approximately $3 million. Management is of the opinion that the claims are without merit and/or that counter claims are available to offset the liabilities, if any.

12. Comparative Figures

The 1984 data in the statement of source and use of cash has been reclassified to conform with the change from the working capital to the cash basis of presentation, and certain other 1984 comparative figures have been reclassified to conform with the financial statement presentation adopted for 1985.

CZAR RESOURCES LTD.
and Subsidiary Companies

Corporate Information

Board of Directors and Officers Czar Resources Ltd.

Robert W. Lamond, Director
Chairman of the Board
& Chief Executive Officer
Calgary, Alberta

Bonita O. Rawlyck, Director
Senior Vice President, Finance
& Chief Financial Officer
Calgary, Alberta

Brian C. Bentz, Director
Vancouver, British Columbia

Charles A. Teare, Director
Calgary, Alberta

Allan R. Twa
Corporate Secretary
Calgary, Alberta

Key Personnel

P. Richard Ewacha
Engineering Manager

Sharon P. Runge
Land Manager

Herbert J. Visscher
Exploration Manager

Paul M. Boechler
Controller

Donald K. Clark
Engineering Superintendent,
British Columbia

Philip W. Payzant
Engineering Superintendent,
Alberta

Officers of Czar Resources Inc., U.S. Subsidiary

Thomas L. Kent
Vice President and
Treasurer

T. William Porter
Corporate Secretary

Corporate Office

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U.S. Office

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Field Office

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British Columbia V1J 4J4
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Legal Counsel

Burnet, Duckworth & Palmer
32nd Floor, 425 First Street S.W.
Calgary, Alberta T2P 3L8

Porter & Clements
3500 Republic Bank Center
Houston, Texas 77002

Auditors

Thorne Riddell
1400, 205 Fifth Avenue S.W.
Calgary, Alberta T2P 2W4

Main Hurdman
4200 Capital Bank Plaza
Houston, Texas 77002

Registrar & Transfer Agents

The Canada Trust Company
505 Third Street S.W.
Calgary, Alberta T2P 3E6

Wholly-Owned Subsidiaries

Czar Resources Inc.
Czar Financing Alberta Ltd.

Stock Listings

The Toronto Stock Exchange

The Alberta Stock Exchange

Trading Symbol — CZR

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CZAR RESOURCES LTD.

INDUSTRIAL GAS SALES

During the period, Czar's deliveries to its industrial gas purchasers steadily increased, mainly due to the start of direct gas sales in British Columbia.

	FIRST HALF 1985	FIRST HALF 1984
	BILLIONS OF CUBIC FEET*	
Alberta - Industrial	4.70	4.71
B.C. - Industrial	1.28	—
B.C. - Export	0.97	—
TOTAL	6.95	4.71

* Includes Czar and partners.

In Alberta, the commencement of production from the Stettler South pool increased deliveries to Alberta Gas Chemicals by an average of 2.5 MMCF/d. A significant well, Nosehill 11-19-55-20 W5M in which Czar has a 15% working interest, began producing in March at rates of up to 5.5 MMCF/d under Czar's Sherritt Gordon contract.

Czar is continuing to supply British Columbia gas to the Cominco plant at Trail, B.C. and to the ammonia plant now owned by CPEX Pacific at St. Helens, Oregon.

The Company presently is awaiting regulatory approval for a direct gas sale to the Mobil Oil Corporation refinery at Ferndale, Washington and has entered into an agreement to supply gas to the Weyerhaeuser facility at Longview, also in Washington. Czar has received United States import approval for the Weyerhaeuser sale, and though the National Energy Board initially denied the export application, recent reductions in fuel oil prices in the Pacific Northwest area, as well as the resolution of transportation and other matters make Czar confident that export approval will be granted.

The Company has entered into direct supply arrangements with two additional British Columbia customers and expects deliveries to commence in early August.

OUTLOOK

The outlook for the oil and gas business was considerably aided by the Federal-Provincial energy agreement or Western Accord, announced on March 28, 1985. In addition to its general aim of reducing government involvement in the business, the gradual reduction of the Petroleum and Gas Revenue Tax as well as the scheduled deregulation of the natural gas industry will directly aid Czar. Further revisions, expected to be made public shortly, to the Alberta royalty and incentive schemes are also expected to assist companies of Czar's size.

Recently, in British Columbia, a number of natural gas projects have been proposed including two new ammonia plants, a potential export of gas for Enhanced Oil Recovery use as well as the LNG project. The high probability that some of these projects will be completed will assist Czar in marketing its B.C. natural gas reserves.

R.W. Lamond
Chairman of the Board

June 21, 1985

D IN CANADA

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CZAR RESOURCES LTD.

INTERIM REPORT TO SHAREHOLDERS

6 MONTHS ENDED APRIL 30, 1985

CZAR RESOURCES LTD.
AND SUBSIDIARY COMPANIES

Rec'd
July 8.
1985

TO THE SHAREHOLDERS

On behalf of the board of directors, I am pleased to report continued increases in cash flow and earnings for the six month period ended April 30, 1985 compared with the prior year. The improved business climate resulting from the recently announced Western Accord coupled with Czar's healthier financial position, should enable the Company to steadily improve its performance during this period of business recovery.

FINANCIAL

Czar revenues of $8.5 million for the first half of 1985 were slightly reduced from the $8.8 million reported in 1984 mainly due to lower processing revenues. The continued lowering of overhead and debt service costs however, resulted in a 26% improvement in cash flow, after payment of preferred dividends, from $2.9 million in 1984 to $3.6 million or $0.31 per share for the reporting period. Increased operating costs during 1985 resulted from start-up costs and higher charges associated with the Company's increasing sales of industrial gas. Earnings increased to $1.9 million in 1985 from $1.6 million in 1984.

The Company's expenditures on fixed assets totalled $2.5 million or 68% of cash flow for the period, comprising low-risk development drilling and production facilities. For 1985, fixed charge coverage of 2.4 times was a marked improvement from the 1.8 times coverage of 1984.

PRODUCTION

Production volumes, net to Czar after royalties, for the first half of 1985 were:

	FIRST HALF 1985		FIRST HALF 1984	
	BOPD	MMCF/d	BOPD	MMCF/d
Canada	283	15.4	267	12.7
United States	90	0.4	122	0.4
TOTAL	373	15.8	389	13.1

Gas production increased by almost two million cubic feet per day over the prior year, helped considerably by improved industrial gas sales during the second quarter. A slight decline in United States oil production was almost fully offset by increased oil and natural gas liquids sales in Canada.

PRODUCT PRICES

In Canada, prices received for both oil and natural gas increased over 1984 prices, while prices declined on average in the United States. Czar anticipates further gas price reductions in the United States during 1985 as the effects of deregulation and competition make themselves felt.

	FIRST HALF 1985		ANNUAL 1984	
	OIL $/BBL	GAS $/MCF	OIL $/BBL	GAS $/MCF
Canada ($ Cdn.)	37.76	2.13	31.36	1.79
United States ($ US)	25.80	3.28	29.83	3.80

CZAR RESOURCES LTD.
CONSOLIDATED STATEMENT OF EARNINGS
SIX MONTHS ENDED APRIL 30, 1985
(Unaudited)

	1985	1984
REVENUE		
Production	$ 8,708,222	$ 8,701,175
Less: Provincial royalties	1,437,549	1,649,348
Freehold royalties	562,658	449,480
Petroleum and gas revenue tax	186,983	384,042
Alberta royalty tax credit	(321,202)	(516,395)
	1,865,988	1,966,475
Net production revenue	6,842,234	6,734,700
Principal and interest from property dispositions	1,436,775	1,473,985
Processing	223,940	557,425
	8,502,949	8,766,110
EXPENSES		
Production	1,603,491	1,069,273
General and administrative	899,171	1,127,402
Bad debts (recovered)	(222,356)	—
Interest on long-term debt	596,538	2,520,616
Other interest	—	686,925
Depletion and depreciation	1,727,837	1,324,071
	4,604,681	6,728,287
EARNINGS BEFORE DEFERRED TAXES, extraordinary item and preferred share dividends	3,898,268	2,037,823
DEFERRED TAXES	1,225,652	—
EARNINGS BEFORE EXTRAORDINARY ITEM AND PREFERRED SHARE DIVIDENDS	2,672,616	2,037,823
EXTRAORDINARY ITEM Reduction of deferred taxes on application of tax costs	1,225,652	—
EARNINGS BEFORE PREFERRED SHARE DIVIDENDS	3,898,268	2,037,823
DIVIDENDS ON PREFERRED SHARES OF A SUBSIDIARY COMPANY	1,982,367	465,240
NET EARNINGS	$ 1,915,901	$ 1,572,583
NET EARNINGS PER COMMON SHARE		
Earnings before extraordinary item	$ 0.06	$ 0.14
Net earnings	$ 0.16	$ 0.13
CASH FLOW PER COMMON SHARE	$ 0.31	$ 0.25

CZAR RESOURCES LTD.
CONSOLIDATED STATEMENT OF RETAINED EARNINGS
SIX MONTHS ENDED APRIL 30, 1985
(Unaudited)

	1985	1984
RETAINED EARNINGS (DEFICIT) AT BEGINNING OF PERIOD	$ 1,472,277	$(46,767,254)
AUTHORIZED REDUCTION OF SHARE CAPITAL APPLIED TO DEFICIT	—	46,767,254
NET EARNINGS	1,915,901	1,572,583
RETAINED EARNINGS AT END OF PERIOD	$ 3,388,178	$ 1,572,583

CZAR RESOURCES LTD.
CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION
SIX MONTHS ENDED APRIL 30, 1985
(Unaudited)

	1985	1984
WORKING CAPITAL DERIVED FROM		
Net earnings	$ 1,915,901	$ 1,572,583
Items not requiring working capital	1,727,837	1,324,071
	3,643,738	2,896,654
Petroleum incentives	119,950	—
Long-term debt	1,765,000	—
Issue of common shares for cash	5,000	—
Preferred shares of a subsidiary company	—	55,000,000
Long-term debt reclassification	—	11,455,112
Long-term receivables collection	—	75,346
	5,533,688	69,427,112
WORKING CAPITAL APPLIED TO		
Long-term debt	—	44,501,040
Fixed assets	2,484,979	1,552,035
Discharge of limited partnership redemption obligations	270,000	270,000
	2,754,979	46,323,075
INCREASE IN WORKING CAPITAL POSITION	2,778,709	23,104,037
WORKING CAPITAL DEFICIENCY AT BEGINNING OF PERIOD	(7,464,420)	(31,144,362)
WORKING CAPITAL DEFICIENCY AT END OF PERIOD	$ (4,685,711)	$ (8,040,325)